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Subcontractors' liability for project delays

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Summary

- The normal way of dealing with damages for delay in a construction contract is to use a Liquidated and Ascertained Damages clause. Such clauses specify a pre-set sum to be due to the client for every day, week or month by which the contractor fails to meet the works completion date.
- However, the greater part of the value of construction work is actually carried out by subcontractors, and there is little or no published evidence as to how their contractual responsibilities for delays are determined and pursued. Theoretically, there are a number of possibilities (none of which is entirely satisfactory to both parties) and the logic and implications of each is discussed.
- A survey was conducted to discover the methods that are actually used, their incidence, and whether it was possible to relate the different approaches to the attributes of particular subcontractors or to specific situations.
- The most commonly encountered approach was for subcontract damages to be based upon a proportion of those set under the main contract. Interestingly, this is neither the approach incorporated within industry-standard subcontract conditions, nor is it the one preferred by subcontractors. Furthermore, this method places considerable risks on the main contractor due to the possibilities of under-recovery and the creation of secondary risks. This method, indeed all the methods that were encountered, seems to be the result of a rather uneasy compromise between the parties, the outcome of which may be related to their relative bargaining power.

Keywords: delay, liability, liquidated damages, subcontracts, bargaining power.

Introduction

Project delays remain a concern in the Construction Industry (National Audit Office, 2001) and problems of causation and liability still abound (Scott et al., 2004). Most construction contracts contain mechanisms for allocating the liability for delays, and compensating for their impact. There are various ways that the contract can encourage timely completion, the most usual being to agree a completion date thus creating a liability (in the form of damages) for any culpable failure to meet it (Thomas and Messner, 2003). At law, the normal principle of damages is that they are there to reimburse the injured party, and must follow the event; though in practice there are distinct advantages to be had by agreeing them in advance (Duncan Wallace, 1995: 1143). It is generally recognised that such Liquidated and Ascertained Damages (LCD) clauses (see, for example

Clause 24 of the JCT Standard Form) are more convenient for all parties. They are particularly useful for projects in which it is difficult to prove any direct commercial loss from delayed completion. In some jurisdictions, such as that of the United States, there still appears to be a tendency to challenge the validity of such clauses (see Jensen, 1998) but in the UK their use is recognized by the courts, which will support such a provision as a 'genuine pre-estimate' even though actual assessment may be difficult or even impossible (Duncan-Wallace, 1995: 1144). LDs have become the most popular and common way of dealing with contractor delays. Indeed, the editor of Hudson's has noted that theoretical discussion of whether a particular LD provision might be construed as a penalty (and therefore unenforceable) may now be considered to be a distraction, since 'their administrative convenience makes it increasingly difficult to attack

successfully ... except in the most obvious cases of excess' (Duncan-Wallace, 1995: 1144).

The rationale for the LD-approach to dealing with project delay is based exclusively on the Employer-Main Contractor relationship, while in reality the majority of project work is actually carried out by subcontractors. Estimates of the extent of subcontracting vary, but the consensus is that it is substantial (see, for example, Ive et al, 2004; MacKenzie et al, 2000; Hughes et al, 1997: 21). Given the well-established principle that the Main Contractor remains liable for any acts or omissions of its subcontractors, there arises the distinct possibility, in any particular project, that the Main Contractor will be delayed (and thereby be at risk of forfeiting LDs) by the non-performance of a subcontractor (see, for example, Abdul-Malak and Hassanein, 2001). Indeed, a report for the National Economic Development Office (NEDC for Building, 1983) attributed 49% of all the delays on the project case studies to subcontractors. Furthermore, it is apparent that this reality has long been recognized by clients and consultants in their reluctance to accept responsibility through nomination. This situation leads to the interesting question of how subcontractors are themselves made contractually responsible to the main contractor for project delays.

The great majority of publications in this area have focused on the main contracts (between client and main contractor) and very few on the ways of dealing with delay in sub-contracts. Hughes et al. (1997: 35) report that liability for delayed completion is 'a source of much discontent among subcontractors', confirming the earlier findings of a survey by Greenwood (1993). As already noted, main contract conditions use the device of LDs to promote timely completion and compensate the employer when late completion by the contractor occurs. In principle, contractors are keen to 'step down' this risk to their subcontractors in some way. However there are serious logical and practical difficulties in establishing a liquidated and ascertained damages sum for each subcontractor involved in a project. On the one hand, the subcontractor is only responsible for its part of the works and in most circumstances would find it intolerable to be made liable for the full extent of LDs payable under the main contract. The compromise approach of fixing subcontract LDs pro-rata to the value of the subcontract is patently illogical: it is quite foreseeable that a single subcontractor could cause a delay to the overall project and the resulting loss to the main contractor could include liquidated damages payable under the main contract, additional delay costs incurred by the main contractor in respect

of his own works, and claims made by other sub-contractors for delay and disruption to their work. In other words, even where the main contract LDs are transferred in their entirety into the subcontract there would be a danger of under-recovery for the main contractor!

The UK standard subcontract forms, such as JCT DSC/Sub Standard Form of Subcontract (Joint Contract Tribunal, 2002), or the earlier DOM/1 Subcontract (Construction Confederation, 1998) contain no liquidated damages provision. For example, DOM/1 clause 12.2 provides that if the subcontractor fails to complete the subcontract works he must 'pay or allow to the Contractor a sum equivalent to any direct loss and/or expense suffered or incurred by the Contractor' (as a result).

This is arguably a most onerous situation for the subcontractor. In this case, the subcontractor's liability for delay damages is unlimited; indeed, given evidence of causation of the relevant delay, the subcontractor's potential liability could be for (i) all of the LDs under the main contract; ii) the relevant prolongation costs of the main contractor; (iii) associated damages claims through the main contractor from other subcontractors. This sum could be many times the value of the value of the subcontractor's work on the project! Thus, the benefits of pre-ascertainment (i.e. knowledge of risk impact) achieved by the incorporation of Liquidated Damages provision in the main contract are lost to the sub-contractor. Price (1994: 168) assumes that 'subcontractors will be aware [of this] when they enter into a sub-contract'. In reality it is possible that not all subcontractors will have a realistic perception of this risk, though when they do (in the case of more contractually-aware subcontractors) negotiations may ensue. These, as Price (1994: 169) has noted, may result in some concession to the subcontractor in the form of the liability being 'capped'. In other words the liability of the subcontractor for delay damages will be limited.

Research Method

In light of the above, a study has been undertaken in order to gain a fuller understanding of how liability for subcontractor delay is actually dealt with in subcontract agreements. To achieve this, the following objectives were set:

- i. to identify, either from the literature, or by a process of logic, all feasible methods by which liability for delay *could be* dealt with in a subcontract;
- ii. to establish the preferences of subcontractors for each method;

- iii. to analyse the occurrence of the various methods used;
- iv. to investigate possible associations between the method adopted, the attributes of the subcontractor involved and the context of the deal itself.

The whole study was conducted with the help and support of the National Specialist Contractors' Council (NSCC). The NSCC is an umbrella organization for specialist contractors in Great Britain. NSCC has 28 trade organisations in membership, representing over 6500 specialist contractors covering the broad spectrum of building specialists within construction (NSCC, 2005). Member organizations range from piling through to the finishing trades. The NSCC has a strong interest in contractual matters, and represents specialist and sub-contractor interests on the Joint Contracts Tribunal (JCT).

IDENTIFICATION OF POSSIBLE CONTRACTUAL APPROACHES

In considering the theoretical possibilities for dealing with the liability for subcontractor delay, seven possible situations were identified, as follows:-

- i.) that the subcontractor is liable under the subcontract for the whole of the main contract LDs ['FULL LDs'];
- ii.) that the subcontractor is liable under the subcontract for the whole of the main contract LDs up to a limit agreed with the contractor; ['FULL LDs + LIMIT']
- iii.) that the subcontractor is liable under the subcontract for an agreed proportion of the main contract LDs; ['PROPORTIONATE LDs']
- iv.) that no LDs apply, and the subcontractor is liable under the subcontract for whatever the contractor's actual loss turns out to be ['ACTUAL LOSS'];
- v.) that no LDs apply, and the subcontractor is liable under the subcontract for whatever the contractor's actual loss turns out to be, up to a limit agreed with the contractor ['ACTUAL LOSS + LIMIT'];
- vi.) that the subcontractor has no liability under the subcontract for delay damages, either in the form of LDs, a variant of LDs, actual losses or actual losses with a limit ['NO LIABILITY'];
- vii.) that the subcontractor is not aware of its liability under the subcontract for delay damages ['DON'T KNOW'].

Situations (vi) and (vii) were included for completeness, despite the fact that situation (vi) was *prima facie* unlikely, and that situation (vii) would be a rather disturbing indictment of the subcontractor's contractual awareness. Opinion relating to sub-contractor prefer-

ence, level of incidence and sub-contractor attributes was sought via a questionnaire survey.

SUB-CONTRACTOR PREFERENCE

It is appreciated that, with regard to the LD options itemized above, practitioners within the construction sector would be able to identify the extreme rankings of sub-contractor preference. However, in order to consider the relative preferences of the full range of options, opinion from the sub-contractor sector was sought. A questionnaire was sent by e-mail to members of the NSCC Contracts Committee, who were asked to rank the options in order of their perception of the commercial preference for a typical subcontractor.

INCIDENCE OF METHODS USED IN PRACTICE

The main purpose of the data collection was to estimate, by means of a questionnaire, how often each of the seven possible situations occurred in practice. This was posted, together with additional explanatory information, to 138 members of the National Specialist Contractors Council (NSCC) Companies were asked to indicate the method of dealing with delay damages that had been agreed with the main contractor on each of their five most recent projects. The rationale of this approach was that it would deter casual guesswork in the response and also permit aggregation of responses. The number of projects (5) was arbitrary, but influenced by the researchers' perception of what would be a reasonable number of recent projects upon which information would be both readily available and current. Anonymity was assured in the covering letter with the intention of avoiding potential bias in response and increasing the rate of return.

ATTRIBUTES OF THE SUBCONTRACTORS INVOLVED

The survey also considered two key factors relating to subcontractor classification; the nature of work undertaken and the size of organization (assessed by annual turnover). These variables have been shown to be important indicators of subcontractor bargaining power (Greenwood, 2001), and hence influential in the contractual outcomes negotiated with the main contractor.

Analysis of results

SUBCONTRACTOR PREFERENCE

Members of the NSCC Contracts Committee were asked to rank the options for treatment of subcontract

delay damages in order of commercial preference. The rankings are shown in the table below.

The preferred situation was for the subcontractor to have no liability at all relating to delays they might cause. However, in practice this is considered to be an unlikely approach. The second preference was 'FULL LDs + LIMIT', i.e. for the subcontractor to be liable for the whole of the main contract LDs up to a limit agreed with the contractor. As previously suggested, this option would normally involve negotiation with the main contractor during the pre-award stage. The third preference was for 'PROPORTIONATE LDs', which would involve an agreed portion of the main contract liquidated damages being applied to the subcontractor (normally pro-rata the value of the subcontract to the whole works value). The fourth commercial preference, was 'FULL LDs', whereby the subcontractor is made liable in full for the main contract liquidated damages in cases where they are held to be responsible for a delay. The least preferable situations were the two that

involved the application of actual damages. Naturally enough, it was preferable to have these limited ('ACTUAL + LIMIT', in 5th place in order of preference) rather than entirely open ('ACTUAL', in 6th place).

INCIDENCE OF USE IN PRACTICE

To examine the incidence of each of the different possible ways of treating delay damages in subcontracts, 138 questionnaires were posted to NSCC companies. Thirty-nine were returned, a response rate of approximately 28%, providing information on 195 individual subcontract packages. The following table shows a ranking of the results.

The most common way of dealing with the prospect of delay damages in subcontracts appears to be the use of a pre-set 'liquidated damages' figure based upon a proportion of the main contract LDs i.e. 'PROPORTIONATE' (36% of projects reported). This is followed by the practice of 'stepping-down'

Table 1: Subcontract delay damages in order of subcontractors' preference (from NSCC Contracts Committee rankings)

Treatment of delay damages		Preference
Abbreviated Reference	Description	Ranking
'NO LIABILITY'	No liability for delays that we cause	1
'FULL LDs + LIMIT'	Liable for the whole of the main contract LDs up to a limit agreed with the contractor	2
'PROPORTIONATE LDs'	Liable for an agreed proportion of the main contract LDs	3
'FULL LDs'	Liable for the whole of the main contract LDs	4
'ACTUAL + LIMIT'	Liable for whatever the contractor's actual loss turns out to be up to an agreed limit	5
'ACTUAL'	Liable for whatever the contractor's actual loss turns out to be	6

Table 2: The incidence of different treatment of delay damages in subcontracts (from NSCC subcontractor survey)

Treatment of delay damages		Incidence
Abbreviated Reference	Description	(% projects)
'PROPORTIONATE LDs'	Liable for an agreed proportion of the main contract LDs	36
'FULL LDs'	Liable for the whole of the main contract LDs	22
'ACTUAL'	Liable for whatever the contractor's actual loss turns out to be	12
'ACTUAL + LIMIT'	Liable for whatever the contractor's actual loss turns out to be up to an agreed limit	11
'NO LIABILITY'	No liability for delays that we cause	9
'FULL LDs + LIMIT'	Liable for the whole of the main contract LDs up to a limit agreed with the contractor	7
'DON'T KNOW'	We do not know what the contractual liability is for delays that we cause	3

Table 3: Nature of work undertaken by respondents

Nature of work undertaken	Number	% of total
Civil engineering	5	13%
Piling and ground engineering	8	20.5%
Landscape	2	5%
Curtain wall, windows and doors	10	25.5%
Roofing and wall cladding	6	15%
Wall and floor tiling	6	15%
Structural fire protection	1	3%
Internal fitting out and refurbishment	1	3%
Total	39	100%

(transferring to the subcontractor) the whole of the main contract LDs (22% of projects reported). The other methods used in practice, in descending order of frequency of use, are: 12% 'ACTUAL' (delay damages to be unspecified and calculated at whatever the contractor's actual loss turns out to be); 9% 'ACTUAL + LIMIT' (similarly unspecified but capped at an agreed limit); 7% 'FULL LDs + LIMIT' (the whole of the main contract LDs up to a limit agreed with main contractor). For 9 % of reported projects, respondents stated that they were not liable for delays that they caused, and on 3% that they 'did not know'.

SUBCONTRACTOR ATTRIBUTES

The 39 firms that responded to the questionnaire had activities that represented a range of commonly-encountered subcontract trades, from ground engineering to internal fitting out and refurbishment (see Table 3). The annual turnover of each of the responding companies varied between £400,000 and £90 million. The latter was one of four firms with turnovers in excess of £50 million, all of which were civil engineering or piling specialists. There were 13 companies with annual turnovers of between £10 million and £50 million; 18 with turnovers between £1 million and £10 million; and four with annual turnovers of £1million or less.

Discussion

Since a substantial proportion of the causes of delays on construction projects are attributable to subcontractors, it is clear that this is an area of potential in terms of risk reduction and risk transfer. However, it appears from the survey that the main contractor retains the main part of this risk in 36% of subcontracts, that is, in cases where there are LDs based upon a proportionate approach. In such situations, main contractors may encounter significant losses when a delay

attributable to a subcontractor occurs. According to the consensus view of the NSCC the preferred method for the application of damages is the one based upon the whole of the main contract LDs, but up to a limit agreed with the contractor. This is not reflected in the results of the survey of methods in use. As shown in Table 2, this approach ('FULL LDs + LIMIT') is used on only 7% of projects, being ranked 5th overall. However, in some types of subcontract works, the use of this proportionate approach is more frequent. For example, from the survey it was apparent that over 50% of total projects in the sector of piling and ground engineering used this approach. At first sight, it seems surprising that main contractors were willing to accommodate much of the risk relating to this type of delay in such a large proportion of their projects. One possible explanation is that these types of work would tend to be on the critical path in the master programme and it is therefore reasonable that the method to deal with delays should be based upon full main contract LDs. At the same time, subcontractors of this type would tend to be more commercially powerful, with relatively greater bargaining power and in a better position to negotiate a limit.

More generally, it appears that where subcontractors are engaged in time critical work, they are more likely to be required to accept full LD risk ('FULL LDs'). One respondent reflected that; 'we [subcontractors] are always on the critical path therefore the main contractor are generally unwilling to reduce their Liquidated and Ascertained damages on our subcontracts. Trades which are non critical are likely to fare better.' Another aspect of relative bargaining power and its effect on the methods adopted for dealing with delay may be market conditions and by the relative importance of the subcontractors' work in the project in question. As the size of a company usually determines the number of potential contracts, larger organisations are likely to be able to negotiate more favourable subcontract conditions since they are more inclined, and able to reject

unfavorable risk. In other words, the relative power of the subcontractor to negotiate with the main contractor declines with size and status. In this context it is interesting to note that it would appear that some subcontractors are able to negotiate less onerous terms (on a project by project basis) than the NSCC (as party to negotiation in the drafting of the standard subcontract form). In any event, it is also accepted that risk attitude is likely to be significantly influenced by market conditions and that onerous risk may sometimes be accepted in response to the need to obtain work and sustain cash flow. Thus, where an adverse tendering climate exists, subcontractors may be prepared to accept disproportionate LD amounts, even where the eventuality may be catastrophic. Where LDs are considered by subcontractors to be unbearable (should circumstances eventuate) a further consideration emerges. The financial stability of the subcontractor may be compromised and may cause entire default of its obligations. Additional LD provision beyond this point becomes meaningless. In such situations, the secondary risk to main contractors is obviously high.

Conclusion

The problem of dealing with liability for subcontractor delay is a significant but under-researched issue in the construction industry. This research shows that despite the level of importance there is very little consensus on a mutually advantageous way of dealing with such delays, as is established in the approach to Liquidated Damages provision in main contracts. From the survey, it has been found that the most common method for dealing with delay liability in subcontract works is to base damages upon a proportion of main contract LDs. It should be noted that this goes against the legal principle that pre-agreed damages should be a genuine pre-estimate of the loss. Indeed, the arrangement may be quite onerous to main contractors in that they may have to compensate the client with large amounts of main contract LDs that are not recoverable from their subcontractors.

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